

**MINUTES OF THE REGULAR MEETING OF THE  
ARIZONA STATE RETIREMENT SYSTEM BOARD**

**HELD ON  
November 19, 2004  
8:30 a.m., MST**

The Arizona State Retirement System (ASRS) Board met in the 10<sup>th</sup> Floor Board Room, 3300 N. Central Avenue, Phoenix, Arizona. Dr. Keith Meredith, Chairperson of the ASRS Board, called the meeting to order at 8:38 a.m., MST.

The meeting was teleconferenced to the ASRS office at 7660 E. Broadway, Tucson, Arizona 85710.

**1. Call to Order; Roll Call; Opening Remarks**

Present: Dr. Keith Meredith, Chairperson  
Mr. Karl Polen, Vice Chairperson  
Ms. Charlotte Borchert  
Mr. Jaime Gutierrez (via teleconference)  
Ms. Anne Mariucci  
Mr. Michael Townsend  
Mr. Lawrence Trachtenberg  
Mr. Steven Zeman

Absent: Mr. Jim Bruner

A quorum was present for the purpose of conducting business.

**2. Approval of the Consent Agenda**

**Motion:** Mr. Karl Polen moved to approve Refunds, Death Benefits, and System Transfers,

*And*

Approve the Applications and Agreements with the following Employers:

- League of Arizona Cities & Towns
- Northern Arizona Council of Governments (NACOG)
- Maricopa County Special Health Care District (effective January 1, 2005)

*And*

Approve the minutes of the October 14, 2004, regular meeting of the ASRS Board,

*And*

Approve the recommended administrative law judge's decision regarding Suzanne Koenig.

Mr. Michael Townsend seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

Ms. Susan G. Sendrow, Attorney representing Suzanne Koenig, addressed the Board regarding Ms. Koenig's appeal. She requested that the Board modify the Office of Administrative Hearing's (OAH) findings and award Ms. Koenig the contributions not withheld for the years she requested.

Mr. Thomas Arn, Attorney for the Peoria Unified School District, addressed the Board. He stated that all information was presented to the OAH and OAH's decision should be approved.

**3. Presentation, Discussion and Appropriate Action Regarding the Administrative Law Judge's Decision for Glen Harless**

Mr. Thomas McClory, Assistant Attorney General, stated that the ASRS and legal counsel for Glen Harless have agreed on a resolution.

The cost to Mr. Harless for coverage for his former spouse as an individual insured participant in the ASRS-sponsored PacifiCare group health coverage for retirees exceeds what the cost otherwise would have been for her coverage. Therefore, the Administrative Law Judge found for Mr. Harless and proposed an order requiring the ASRS to pay all past costs (\$11,453.06) and future costs (\$137.48/mo.) for dependent coverage. The proposed settlement is for \$14,000 with no future obligation on the part of the ASRS.

**Motion:** Mr. Karl Polen moved to approve the settlement proposed by counsel and staff, and substitute the agreement for the decision of the Administrative Law Judge.

Ms. Charlotte Borchert seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

**4. Presentation, Discussion and Appropriate Action Regarding the Notice of Rulemaking Docket Opening and Notice of Proposed Rulemaking for R2-8-115, Termination of Membership, and R2-8-118, Allocation to Funds, and includes the Change to 4% Interest on Funds Withdrawn by Plan Members**

Ms. Nancy Johnson, Rules Coordinator, stated this involves an amendment to two current ASRS rules, R2-8-115 and R2-8-118. When a rule is amended, the entire rule must be reviewed and, if necessary, amended. These rules were last amended in the 1980s, and are extremely out of date. Therefore, the ASRS is required not only to amend the interest rate on withdrawal of plan members' contributions, but to amend the rules so they are clear, concise and understandable, and reflect our current procedures.

This rulemaking amends R2-8-115 to update and clarify the procedure for the return of contributions when a member who has terminated or terminates employment by other than retirement or death, and the procedure for requesting survivor benefits upon the death of a member. The rulemaking also amends R2-8-118 to clarify the various interest rates allocated for various purposes in the past, and includes the change to 4% interest on funds withdrawn by Plan members, but not System members.

**Motion:** Ms. Charlotte Borchert moved to approve the Notice of Rulemaking Docket Opening for R2-8-115 and R2-8-118,

*And*

Approve the notice of Proposed Rulemaking for R-2-8-115 and R2-9-118.

Mr. Steven Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

**5. Presentation, Discussion and Appropriate Action Regarding the Notice of Final Rulemaking for Article 4, Practice and Procedure before the Board (Appeals)**

Ms. Johnson stated that the proposed rulemaking was filed with the Secretary of State, and an oral proceeding was held on October 25, 2004. No comments were received about these rules prior to the close of record at 5 p.m., October 25, 2004. Therefore, the rules in the Notice of Final Rulemaking are identical to the rules in the Notice of Proposed Rulemaking.

**Motion:** Mr. Michael Townsend moved to approve the Notice of Rulemaking for Article 4, Practice and Procedure before the Board

Mr. Jaime Gutierrez seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

**6. Presentation, Discussion and Appropriate Action Regarding Possible Legislative Issues for the 2005 Legislative Session**

Ms. Denisse Gee, Government Relations Officer, stated that the ASRS presently allows employees who change employment between ASRS employers the choice of whether to transfer their Payroll Deduction Agreement (PDA) to the new ASRS employer, even if this constitutes a termination of the statutorily stated "current employment." Additionally, if an employee changes positions with the same ASRS employer, the ASRS allows the employee the option of deciding whether their PDA will continue with the change of position.

Both of these current practices now appear to be questionable under existing state law and Internal Revenue guidelines.

**Motion:** Mr. Jaime Gutierrez moved to direct ASRS staff to draft, seek sponsorship introduction and favorable disposition of appropriate legislation to amend existing statute to provide that payroll deduction agreements must continue for an employee when changing employment between ASRS participating employers.

Ms. Charlotte Borchert seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

#### **7. Presentation, Discussion and Appropriate Action Regarding the System Actuarial Valuation**

Mr. Charles Chittenden, Actuary, and Ms. Eva Yum, Actuary, Mellon Human Resources and Investor Solutions presented to the Board. Mr. Chittenden and Ms. Yum stated the following facts regarding the System Actuarial Valuation: there has been a decrease of non-retired System members; there are currently 287 non-retired System members; total of balances is \$140.8 million; the average balance is \$490,592; the average age is 63; the funded status for the System is 106.64%. They also discussed the liabilities for non-retired, annuities, and the 13<sup>th</sup> check.

**Motion:** Mr. Karl Polen moved to accept the Actuarial Valuation of the System for the period ending June 30, 2004.

Ms. Anne Mariucci seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

#### **8. Presentation, Discussion and Appropriate Action Regarding Calculation and Treatment of the Allocation of Excess Surplus (13<sup>th</sup> Check) for System Members**

Mr. Chittenden stated that the actuarial valuation for the year ended June 30, 2004, indicates that the funded status of the system is 106.6%.

If the Board were to allocate surplus, and reduce the funded status to 105%, the allocation would provide a very small increase (about 1.6%) in member benefits and accounts.

Investment returns so far in fiscal year 2005 have been on target to match, with some volatility, the actuarial assumption of 8%. If the return for 2005 is less than 8%, the System will have an actuarial loss, and such a loss will be fully reflected in the funded status as of June 30, 2005. If the funded status declines below 95%, the Board must reduce benefits, and if the funded status declines below 100%, there would be reliance on investment earnings to be above 8%.

Mr. Uwe Fink, a member of the System addressed the Board. He strongly agrees with the recommendation that the Board not allocate excess surplus.

Ms. Bev Cuthbertson, asked the Board for clarification on the distribution of 13<sup>th</sup> check.

Mr. Richard Stephenson, Deputy Director, External Affairs, stated that the 13<sup>th</sup> Check represents a distribution of excess earnings from the past. The money is equitably distributed between all members (retired and non-retired). For non-retired members the money is deposited into their account and is annuitized upon their retirement and becomes part of their monthly pension check. For retirees, the excess earnings were annuitized and added into retiree's 13<sup>th</sup> Check. Excess earnings in the future could be distributed among all members as new annuities.

**Motion:** Mr. Michael Townsend moved that the Board not allocate excess surplus above 105% to System Members and System Members' beneficiaries.

Ms. Charlotte Borchert seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

## **9. Presentation, Discussion and Appropriate Action Regarding the Plan Actuarial Valuation**

Mr. Chittenden and Ms. Yum provided the following statistical information regarding the Plan Actuarial Valuation: the ASRS currently has 205,482 active members, and 69,049 retired members; the active payroll is \$7.486 billion; the average annual salary is \$36,429; the average annual benefit is \$17,837; the market value of assets is \$20.746 billion, and actuarial is \$23.643 billion; the estimated yields on assets for actuarial is 2.46% and 17.37% for market; benefits and refunds are \$1,350 million and contributions are \$866 million; the external cash flow percentage of market value is currently -2.33%; the surplus (unfunded accrued liabilities) is \$2,275 million; the GASB #25 funded ratio is currently at 92.5%. Based on the valuation, the contribution rate for the plan for FY 05/06 is 7.75%. The permanent benefit increase for 2005 is \$25.90.

Mr. Heb Weil, representing the Deer Valley Education Association, addressed the Board. He stated that the state provided a 2% budget increase, and the district needs 2.5% to fund the current salary schedule. Due to an increase of medical benefits and cost of living, teachers are taking home less money. Increase in contribution rates for next year magnifies the issue. He stated maybe the increases could be smaller and more frequent to allow teachers to keep as much of their salary as possible.

Ms. Shirley Filliater-Torres, representing the Phoenix Union Classroom Teachers' Association, addressed the Board regarding the increase of contribution rates. Salary increases for teachers are not keeping up with increasing medical and contribution rates. Two years ago the contribution rate increased by 3.5%, salaries did not increase, the district made cuts to approach the 3.5% increase. Many employees in the district suffered a cut in take-home pay and an increase for dependent-care health insurance coverage. Last year the district received a 1% increase in pay, but dependent-care health insurance increased again. The Teachers' Association has a members' fund that offers small loans for emergency situations, there has been a drastic increase for loans this year. Ms. Filliater-Torres is worried that the district will lose valuable teachers if improvements are not made to their financial situation. She suggested contribution rates be increased every year.

Dr. Keith Meredith stated that the ASRS is constitutionally bound to offer suggestions/recommendations that are actuarially sound. The ASRS Board has changed to a 10-year smoothing period, allowing contribution rates not to increase so dramatically.

Mr. McClory stated that the ASRS is bound by state statute to make changes to contributions over a two-year cycle, and cannot do it more often without legislative changes to state law.

**Motion:** Mr. Karl Polen moved to accept the Actuarial Valuation of the Plan for the period ending June 30, 2004.

Mr. Michael Townsend seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

#### **10. Presentation, Discussion and Appropriate Action Regarding the Long Term Disability (LTD) Actuarial Valuation**

Mr. Chittenden and Ms. Yum provided some history about the LTD plan. In 1995, the LTD Program split off from the plan, becoming a health plan not a retirement plan. As a health plan it qualified under section 105 of the Internal Revenue Code, rather than section 400, which does not allow the ASRS to move money from one code section to another. The LTD Program started with no assets and about 100 million dollars of liabilities for claims that had been incurred before the split. The actuary developed a methodology to amortize some of the liability rather than paying it all off.

Mr. Chittenden stated that the ASRS LTD program funded status has grown from 44.2% to 51.0%, the highest it has been. The components of the contribution rate include the projection of the cash costs and amortization of reserve. Mr. Chittenden suggested that the LTD program be changed to a fifteen-year rolling period. LTD contribution rate is at 0.50%.

**Motion:** Ms. Anne Marriucci moved to accept the Actuarial Valuation of LTD with a 15-year amortization schedule for the period ending June 30, 2004.

Mr. Steven Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

#### **11. Presentation, Discussion and Appropriate Action Regarding the LTD Program Asset Allocation**

Mr. Gary Dokes, Chief Investment Officer, stated that the Investment Review Committee (IRC) approved recommendations at the September 9, 2004 meeting, to modify the LTD Program Asset Allocation. The ASRS has used identical asset allocation policies for the ASRS Plan and LTD program. On August 15, 2003, the Board approved a new asset allocation policy for the Plan consisting of 53% U.S. Equity, 15% International Equity, 26% U.S. Fixed Income, and 6% Real Estate, effective October 1, 2003. The LTD program was not changed and has continued to use the prior asset allocation policy. The Investment Management Division expects that the performance of the LTD portfolio using the proposed allocation and BGI funds should

outperform the existing portfolio by 50-100 basis points per annum, net of fees. For 2003, the LTD portfolio produced an official net return of 22.2%, compared to 23.4% for a hypothetical portfolio using the BGI enhanced funds in the existing policy weights.

**Motion:** Mr. Lawrence Trachtenberg moved to modify the LTD Program's Asset Allocation Policy to match the ASRS Plan, as follows:

<b>Asset Allocation Policy for LTD Program</b>		
<b>Asset Class</b>	<b>Current Allocation</b>	<b>Proposed Allocation</b>
U.S. Equity	53% $\pm$ 3%	53% $\pm$ 5%
International Equity	17% $\pm$ 3%	15% $\pm$ 5%
U.S. Fixed Income	30% $\pm$ 3%	26% $\pm$ 5%
Real Estate	0%	6% $\pm$ 2%

*And*

Approve an additional allocation to Barclays Global Investors' (BGI) Real Estate Securities Index Fund.

*And*

Authorize BGI to migrate assets from BGI's Passive Index Funds for U.S. Large Cap Equity (S&P 500), International Equity (MSCI EAFE), and U.S. Fixed Income (Lehman Aggregate) to the BGI Enhanced Funds: U.S. Equity Alpha Tilt (Russell 3000), International Equity Alpha Tilt (MSCI EAFE), and U.S. Income Core Active (Lehman Aggregate).

Mr. Karl Polen seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

## **12. Presentation, Discussion and Appropriate Action Regarding the Small Cap Growth Investment Manager Search**

Mr. Dokes stated due to the termination of Columbia Asset Management as the ASRS U.S. equity active small cap growth manager in July 2004, a Small Cap Growth Manager Search Committee was formed and began the search process for a replacement small cap growth manager(s). Committee members included the CIO, the IRC Chair, the ASRS Equity Portfolio Manager, ASRS Senior Portfolio Analyst, and Mercer Investment Consulting. As a result of work performed by IMD/Mercer and Committee discussions, a list of five finalist managers were selected to be interviewed. The recommendation to hire Artisan and Batterymarch is based on the Small Cap Growth Manager Search Committee's expectation of these managers' ability to add value consistently relative to the benchmark.

**Motion:** Mr. Lawrence Trachtenberg moved to select the following U.S. Equity Active Small Cap Growth Managers:

Artisan Partners  
Batterymarch

***And***

Approve to allocate the mandate of approximately \$220 million equally between the two managers, resulting in a portfolio size of \$110 million for each manager.

***And***

Move to terminate and defund BGI as temporary ASRS U.S. Equity Passive Small Cap Growth Manager.

Mr. Steven Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

### **13. Presentation, Discussion and Appropriate Action Regarding the Board Meeting Schedule for the Calendar Year 2005**

The 2005 Board meeting schedule was modified from a twelve meeting schedule to a ten meeting schedule. All Board meetings will be held in Phoenix. The following are meeting dates for calendar year 2005: February 18, March 18, April 15, May 20, July 15, August 19, September 16, October 21, November 18, and December 16.

**Motion:** Mr. Michael Townsend moved to approve the ASRS Board Meeting Schedule for Calendar Year 2005.

Mr. Steven Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

### **14. Director's Report**

Mr. Anthony Guarino, Deputy Director, Chief Operations Officer, provided an overview of the service levels. The ASRS has been attempting to accomplish three objectives, implement legislative and policy changes, modernize business functions and manage increasing workloads. The ASRS does not have the manpower or capacity to meet all three objectives efficiently at the same time. The ASRS is vulnerable to sudden spikes in service demands which happened when the ASRS began charging interest on PDAs. The number of service requests for service purchase is 60% higher than this time last year (21,000 requests vs. 13,000 in 2003). The ASRS is operating with 30 fewer full-time employees (FTE). The more automated service purchase system that the ASRS was hoping would provide a positive impact was not ready upon implementation. This was the first time the ASRS attempted to integrate all of our systems with each other. On the positive side the ASRS sent out 1,300 cost letters last month, and are projecting sending 3,000 or more out this month. A task force is addressing quality issues that have surfaced, and they are filling gaps in training, procedures and programming. The next several months are going to continue to be difficult, but the ASRS will ultimately normalize this service and will begin to meet long-term service objectives.



Mr. Paul Matson, stated that staff is resolving outstanding LTD audit issues, and hopes to provide a presentation at the February 18, 2005, Board Meeting.

Mr. Matson congratulated Mr. Richard Stephenson, Deputy Director, External Affairs, on his retirement. He is retiring effective December 3, 2004.

#### **15. Possible Presentation and Discussion Regarding Board Committee Updates**

Mr. Jaime Gutierrez, Chairperson, External Affairs Review Committee, stated the Committee will have a meeting on December 3, 2004. The Committee will continue to have the External Affairs Committee meetings on the first Friday of the month for calendar year 2005.

Mr. Lawrence Trachtenberg, Chairperson, Investment Review Committee, stated there will be a Committee meeting on December 7, 2004, to discuss Mid-Cap managers.

Ms. Charlotte Borchert, Chairperson, Operations Review Committee, stated that the November and December ORC meetings have been canceled. The next ORC meeting will be held on January 27, 2005.

#### **16. Board Requests for Agenda Items**

No additional requests to speak.

#### **17. Call to the Public**

None.

**18. The next ASRS Board meeting is scheduled for Friday, December 17, 2004, at 8:30 a.m., at 3300 N. Central Avenue, 10<sup>th</sup> Floor Board room, Phoenix, Arizona.**

#### **19. Adjournment of the ASRS Board**

Dr. Meredith adjourned the November 19, 2004, Board meeting at 10:45 a.m.

ARIZONA STATE RETIREMENT SYSTEM

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Erica Romero, Secretary

Date

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Paul Matson, Director

Date